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Supreme Court, U. S.
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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, A. D. 1937

No. 446

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

vs.

ELBE OIL LAND DEVELOPMENT COMPANY,

Respondent.

Brief for Respondent.

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Brief for Respondent.

Opinions Below.

The opinion of the Board of Tax Appeals (R. 69-76) is reported in 34 B. T. A. 333. The opinion of the Circuit Court of Appeals (R. 86-91) is reported in 91 F. (2d) 127.

Jurisdiction.

The judgment of the Circuit Court of Appeals was entered June 21, 1937 (R. 91). The petition for a writ of certiorari was filed September 21, 1937, and granted November 8, 1937 (R. 92). The jurisdiction of this Court is conferred by Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

Question Presented.

The question is whether the annual payments of $400,000 each received by the taxpayer in the years 1928 and 1929 under an agreement dated October 3, 1927, were "gross income from the property" within the meaning of that phrase as used in Section 114(b)(3) of the *Revenue Act of 1928*, so as to entitle the taxpayer to a depletion allowance of 27½ percent thereof under the provisions of that section.

Statutes Involved.

Section 23 (l) of the Revenue Act of 1928, under which the allowance for depletion is granted, and Section 114(b)(3) thereof, which prescribes the basis for the allowance under Section 23 (l) in the case of oil and gas wells, are correctly set forth by the Commissioner in his brief, pp. 2-4, and are shown herein in the Appendix, *infra*, pp. 29-30.

Statement.

The Commissioner's statement of facts, pp. 4-6 of his brief, is inaccurate and incomplete. On page 5, he says that the "consideration of $2,000,000 was to be paid without reference to and without being in any manner based upon the production of oil from the properties." The statement in the record cited to this effect (R. 71) is an inference of the Board from the contract of October 3, 1927 (R. 37-64). There is nothing in that contract requiring that the payments be made without reference to production. The payments to be made on March 14, 1928, and March 14, 1929, being the payments involved in this controversy, were optional with Honolulu (R. 54-58). Prior thereto, beginning as of October 3, 1927, Honolulu was already in possession of the properties under the contract (R. 34). Between October 3, 1927, and March 14, 1928, the date of the first optional payment, it (and its

assignee, Shell) spudded in and completed 5 wells; and between the latter date and March 14, 1929, the date of the second optional payment, it spudded in and completed 7 more wells (R. 67-68). There is nothing in the contract of October 3, 1927, which prevented Honolulu from considering the results of production in determining at the time of each optional payment, whether to make the payment or return the properties to the taxpayer. If, moreover, it decided to return the properties to the taxpayer, it retained the right to the possession of all oil wells which had been completed or were in process of drilling until such time as it had been reimbursed for all its expenditures, including the payments already made to the taxpayer (R. 55-58). And if it retained the properties, it was entitled to be reimbursed from production for these payments before any royalties were due the taxpayer on account of its one-third share in the net profits (R. 48-49). There is no basis, therefore, for the inference that the "consideration of $2,000,000 was to be paid without reference to and without being in any manner based upon the production of oil from the properties."

Again, on page 6 of his brief, the Commissioner says that on its return for 1927, the taxpayer treated the transaction as a sale. The pages in the record cited (35, 71) are barren of any such fact. It is a mere inference of the Commissioner, and will be considered herein under the head of Argument.

In addition to the facts stated by the Commissioner it should be observed that Honolulu bound itself to the taxpayer to perform all work and labor required under the permits and leases transferred to it and to pay the royalties required thereunder to the United States, the original permittees, and the original lessors (R. 45-47), provided, however, that it might surrender to the taxpayer the prop-

erties or any part thereof, and be thereupon released of said obligation assumed with respect to the properties surrendered (R. 60).

Moreover, Honolulu was required to render monthly statements of operations to the taxpayer (R. 59), with right in the taxpayer to examine the books of Honolulu and to have audits made of them (R. 59), and to come upon and examine any of the properties (R. 61). And from the very beginning Honolulu was required to pay the taxpayer, monthly, the latter's reserved one-third of the net profits from the properties after reimbursement of Honolulu for its expenditures under the contract, including the annual payments so far made to the taxpayer (R. 46-54).

SUMMARY OF ARGUMENT.

The nature of the contract of October 3, 1927, cannot be determined from any one paragraph thereof, but only from the entire contract and every part of it, and more especially from the paragraphs directed to particular matters. There is, also, no burden on the taxpayer to show that any paragraph of the contract was not a paper provision. Moreover, the charge that the provision reserving to the taxpayer a one-third interest in the net profits was a paper provision, that there was no reasonable expectation that any payments would be made under that provision, and that the transaction was therefore a purchase by Honolulu for $2,000,000 of an equivalent amount of oil in the ground, is utterly inconsistent with reality. In any case, that charge, being in the nature of an affirmative defense, is improper because now made by the Commissioner for the first time. At least, the taxpayer would be entitled to have the case remanded to the Board so that it might introduce evidence in this respect. Upon a consideration of the entire contract including the provision reserving to the taxpayer a one-third interest in the net profits, the transaction between Honolulu and the taxpayer was not a sale.

Nor does Honolulu's right to reimbursement make the transaction *pro tanto* a sale, nor does it affect the character of the payments involved as bonus or advance royalty. A sale, for $2,000,000, of an equivalent amount of oil in the ground, would not be reasonable. To so interpret the contract, moreover, would require a separation of the contract into two contracts, the one pertaining to reimburse-

ment out of production and the other pertaining to the share in the net profits. But the contract can only be interpreted as not separable.

There is, of course, a single allowance for percentage depletion which must be "equitably apportioned" between those entitled to share therein. However, this would not require denial of percentage depletion to the taxpayer on the payments here involved merely because Honolulu "owned" the oil produced to the extent necessary for reimbursement of those payments; for, as bonus, those payments would be deductible by Honolulu from the gross proceeds "owned" by it in computing its gross income for the purpose of percentage depletion. Thus, the necessity of ownership, as a basis for depletion, of the oil produced or proceeds thereof, does not apply to depletion on bonus or advance royalties.

Nor is the taxpayer to be denied depletion on the amounts thus received as bonus because its reserved interest in the properties is a right to share in the net profits instead of the gross. An interest in the net income from property is an interest in the property itself. The property here being oil, in place, an interest therein is necessarily depleted by production. It follows that the taxpayer's reserved interest is an interest in the oil in place, depleted by production. Moreover, denial of percentage depletion upon payments received out of net profits would be mathematically inconsistent with the statutory limitation on percentage depletion based on net income of the taxpayer from the property. Finally, the taxpayer here was the discoverer of the oil. The special depletion allowances having been granted by Congress because of its policy favoring the discoverer of the oil, that policy should not be defeated here merely because the reserved interest of the taxpayer was based on net instead of gross proceeds.

ARGUMENT.

I.

The nature of the contract of October 3, 1927, must be based upon the ruling intention of the parties as determined, not from any one paragraph thereof, but from the entire contract and every part of it, and more especially from the paragraphs directed to particular matters.

The Commissioner urges first that the contract between the taxpayer and Honolulu constituted a sale, and in support of that conclusion states that the contract "specifically provided that it was the intention of the parties that full and complete ownership of the properties should vest in Honolulu and the taxpayer should 'have no interest in or to any of said properties whatsoever.'" (Brief for Petitioner, p. 12.) Thus the Commissioner relies upon an expression of the parties as to the effect of the contract, contained in paragraph 3 thereof (R. 44-45). The effect of a contract, however, can only be determined from a consideration of every part of it, and more particularly from the paragraphs directed to particular matters.

This Court has dwelt often on this point involved in the interpretation of contracts. An instrument, this Court has held, should be interpreted by the context so as, if possible, to give a sensible meaning and effect to all its provisions; and so as to avoid rendering portions of it contradictory and void. *Ladd* v. *Ladd*, 8 How. 10, 28. Again, the true construction of a contract is not to be found in any name which the parties may have given to it, and not alone in any particular provisions it contains, disconnected from all other, but in the ruling intention of the

parties, gathered from all the language they have used. *Heryford* v. *Davis,* 102 U. S. 235, 243. Applying the rule to the facts, this Court there said, at page 245:

> "It is quite unmeaning for parties to a contract to say it shall not amount to a sale, when it contains every element of sale."

In another case, *O'Brien* v. *Miller,* 168 U. S. 287, a provision in a bottomry bond that it be void in case of complete loss of a named vessel was held not controlling when, there being two vessels involved in the bond, other provisions showed that the defeasance clause was intended to be effective only if both vessels were lost. In interpreting a contract, this Court there held, at page 297, the whole contract must be brought into view, and it must be interpreted with reference to the nature of the obligations between the parties, and the intention which they have manifested in forming them; and even the lack of ambiguity in certain words when standing alone does not necessarily relieve them from the necessity of construction in ascertaining the meaning of the entire contract.

Again, in *Green County* v. *Quinlan,* 211 U. S. 582, this Court pointed out, at page 594, that in ascertaining the true meaning of instruments in writing courts do not confine their attention to single words, phrases or sentences, but the meaning is sought from the whole instrument viewed in the light of the subject with which it deals, and the intent is thus reached though the result be to disregard technical meanings. In still another case, *Mutual Life Insurance Co.* v. *Hill,* 193 U. S. 551, a provision in a contract that it be considered as having been made in New York was held not to prevent its limitation by other express provisions, such as waiver of notice although New York law prohibited forfeiture without notice. Where

there are two clauses in a contract, this Court pointed out, at page 558, conflicting in any respect, that which is specially directed to a particular matter controls in respect thereto over one which is general in its terms, although within its general terms the particular may be included, and this because, when the parties express themselves in reference to a particular matter, the attention is directed to that, and it must be assumed that it expresses their intent, whereas a reference to some general matter, within which the particular may be included, does not necessarily indicate that the parties had the particular matter in thought.

All this must be especially borne in mind here; for in taxation our concern is with realities, not nomenclature. *Senior* v. *Braden*, 295 U. S. 429. In *Palmer* v. *Bender*, 287 U. S. 551, although the instrument used the words "sell, assign, set over, transfer and deliver," this Court referred to the cash payment of $3,000,000 involved, not as proceeds of a sale, but as a "cash bonus." Thus, as pointed out in *Green County* v. *Quinlan, supra*, the true meaning of the writing was not based on single words, phrases, or sentences, but on the whole instrument viewed in the light of the subject with which it dealt.

The conclusion must be that the entire contract, and every part of it, and more especially the paragraphs directed to particular matters, must be examined and given weight in determining the nature of the contract of October 3, 1927.

II.

Upon a consideration of the entire contract, the transaction between the taxpayer and Honolulu did not constitute a sale.

The reservation of interest by the taxpayer in the net profits of the properties transferred (R. 48-56); the requirement that Honolulu render monthly statements of operations to the taxpayer (R. 59); the reservation by the taxpayer of the right to examine the books of Honolulu and to have audits made of them (R. 59); the provision that Honolulu might secure release from this and all other obligations with respect to any of the properties by surrendering such properties to the taxpayer (R. 60); the reservation by the taxpayer of the right to come upon and examine any of the properties (R. 61);—all these are provisions in the contract with respect to the properties transferred wholly inconsistent with the notion of a sale. If Honolulu assigned to a third party the leases and permits transferred to it by the taxpayer, such third party, unless an innocent purchaser, would be accountable to the taxpayer in Honolulu's stead. *Shiffman* v. *Richfield Oil Co. of California,* 93 Cal. Decisions 114, 64 P. (2d) 1081 (1937). In the case last cited the interest involved was in the *net* proceeds and the court expressly held (p. 1088) that such an interest stood in the same position, as against assignees of the lease, as a percentage in the oil itself. See also *Akin* v. *Marshall Oil Co.,* 188 Pa. 602, 41 Atl. 748, 751. Thus the taxpayer here reserved a permanent interest in the properties transferred, good against anyone but an innocent purchaser. Where the transferor of a lease reserves any interest therein, whether it be a portion of the term, or some estate or interest in the premises, the trans-

fer is a sublease. *Barkhaus* v. *Producers' Fruit Co.*, 192 Cal. 200, 219 Pac. 435, 437. It is clear then that the transaction between the taxpayer and Honolulu was a sublease, not a sale.

The Commissioner now contends, however, that the taxpayer himself treated the transaction as a sale. (Brief for Petitioner, pp. 6, 7, 13.) There is nothing in the record to support this notion. The Commissioner predicates it entirely on the fact that in reporting its income for 1927 the taxpayer deducted from the payment of $350,000 received in that year under the contract, the entire cost of acquiring and developing the properties transferred. This the taxpayer did in accordance with *Murphy Oil Co.* v. *Burnet*, 287 U. S. 299, 304, where this Court sustained the Commissioner in treating an amount, received as bonus, as entirely a recovery of cost. The depletion allowance for 1927, under the statute, could not have been less than it would have been if computed without reference to percentage depletion.[1] It follows, therefore, that if the cost, deductible under the principle of the *Murphy Oil Co.* case, was greater than percentage depletion, that is, 27½ per cent of $350,000, such cost was the proper amount to be deducted for 1927 *as depletion*. The deduction by the taxpayer of the entire cost in 1927 is thus no basis for the conclusion that the taxpayer himself treated the transaction as a sale. Even if the taxpayer had, in 1927, erroneously treated the transaction as a sale, or erroneously deducted the entire cost, that would be no basis for any conclusion here. *McEachern* v. *Rose*, 302 U. S. 56, 59-60. There are no grounds for

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1. U. S. C. A., Title 26, Par. 935, quoted in *Helvering* v. *Twin Bell Syndicate*, 293 U. S. 312, 314. It will be observed that the statutory provisions covering percentage depletion for 1927 were the same as for the years here involved and set out in the Appendix, *infra*, pp. 29-30.

estoppel; nor does the Commissioner raise that issue; nor has he heretofore raised it so as to be entitled to present it now. *General Utilities Co.* v. *Helvering,* 296 U. S. 200, 206; *Helvering* v. *Salvage,* 297 U. S. 106, 109.

The Commissioner, however, observing that the transaction between the taxpayer and Honolulu may not be a sale in view of the taxpayer's reservation, under paragraph 8 of the contract, of an interest in the net profits of the properties, now charges that no reasonable expectation exists that payments ultimately will be made under paragraph 8—that paragraph 8 may have been nothing more than a paper provision. (Brief of Petitioner, pp. 13-14.) This is a complete shift of ground. Never before in this proceeding has the Commissioner presented that ground. At least the taxpayer would be entitled to have the case remanded to the Board so that it might have an opportunity to submit evidence on the point. *Helvering* v. *Gowran,* 302 U. S. ....., decided December 6, 1937; *Helvering* v. *Rankin,* 295 U. S. 125, 131. The taxpayer is prepared to present evidence showing that production was slowed up by proration,[2] and that there is a reasonable expectation that payments will be made under paragraph 8.[3]

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2. Curtailment of oil production under proration agreements and statutory provisions has been common in this country for several years. Beginning in 1930, Congress recognized the importance of such agreements for the purpose of conservation of natural resources. It authorized them on lands held under federal permit, and required that they vest in the proper federal department control over the rate of prospecting, development and production. 30 U. S. C. A., Par. 184, 226, as amended by 46 Stat. 1007, 1523.

3. Far from being secret, production and reserve data with respect to particular oil fields are widely published. Voluminous detail with respect to the "Round Mountain" field, the oil field herein involved (R. 66), as of the time

Such remand, however, should not be necessary. It may be true that the burden is upon the taxpayer to establish its right to the depletion allowance. But that does not place upon it the burden of showing that any paragraph of the contract involved was not a paper provision. The taxpayer's burden of proof does not require it to negative all possible defenses; the Commissioner's affirmative defenses are for him to prove. *Appeal of Kenefick,* 3 B. T. A. 659, 663; *American Ideal Cleaning Co.* v. *Commissioner,* 30 B. T. A. 529; *Roach* v. *Summers,* 20 Wall. 165,

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when this proceeding was before the Board (the stipulations were filed September 18, 1933, and January 30, 1934,—R. 2) can be found in several publications. In *Petroleum World,* 1934 Annual Review (Library of Congress catalog number TN860.P6), there appears, on pages 74-94, a complete detail of production and potentials in California for 1933. Only three companies are therein indicated to have had wells in the "Round Mountain" field in 1933: California Western Oil Co. (page 77) with 1 well and potential of 79 barrels per day, Honolulu (page 82) with 9 wells and potential of 5,430 barrels per day, and Shell (page 89) with 24 wells and potential of 4,260 barrels per day. (A detail of the wells of Honolulu and its assignee, Shell, as of approximately the same time, is given in the record, R. 67-68). Thus the properties involved in this proceeding are shown to have represented 33 out of 34 wells and a potential of 9,690 barrels per day out of a total potential of 9,769 in the "Round Mountain" field, or 99.2%.

Estimates of the available oil reserve of the "Round Mountain" field are given in the same publication, page 30, also in the *Oil and Gas Journal* (Library of Congress catalog number TN860.O4) for September 20, 1934, page 55, and also in the 1934, 1935, and 1936 volumes of *Petroleum Development and Technology* (a publication of the American Institute of Mining and Metallurgical Engineers, Library of Congress catalog number TN860.A4). As in-

170; *Sullivan* v. *Capital Traction Co.*, 34 App. D. C., 358, 368. The defense being affirmative, and not having been presented to the Board, nor to the Court below, it cannot be presented now. *Helvering* v. *Salvage, supra.*

The Commissioner, moreover, himself indirectly denies that the provision for payments under paragraph 8 was a mere paper provision; for he admits (p. 23 of his brief) that the parties took the trouble to set up an elaborate mechanism for their computation. Furthermore, the

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dicated in the latter publication (1934 volume, pages 189-192, lines 23 and 35), the estimates of the remaining reserves as of January, 1934, ranging from 35,000,000 to 45,000,000 barrels, include "Coffee Canyon" field, which was later segregated in that publication with an estimate of 8,000,000 barrels as of the same date (1935 volume, pages 259-266, line 68.) Thus the estimated remaining reserves of the "Round Mountain" field as of January, 1934, as reported in these publications, range from 27,000,000 to 37,000,000 barrels. A report of J. R. Pemberton, Oil Umpire for Central Committee of California Oil Producers, as of January, 1935, entitled "Vital Statistics of California Oil Fields," and showing a reserve of 31,500,000 barrels for "Round Mountain," may be had in the office of Edward B. Swanson, Associate Director of Conservation, Room 7315, U. S. Department of Interior, South Building, Washington, D. C.

The prices of "Round Mountain" oil, at the well, are indicated in the same issue of *Petroleum World* mentioned above, page 63, to have ranged from 49¢ to 57¢ per barrel during the period from October 22, 1928, up to 1934. Thus at the time the stipulations of fact were filed with the Board in this proceeding, the published estimates indicate the remaining available oil in the "Round Mountain" field to have been worth, at the well, from $14,000,000 to $20,000,000. Of this amount the properties involved in this proceeding, as determined by the published reports of potential in barrels per day, represented, as pointed out above, 99.2%.

notion that paragraph 8 was a paper provision is impossible. If there was no reasonable expectation of payments to the taxpayer out of its one-third share in the net profits, under paragraph 8, it necessarily follows that there was no reasonable expectation by Honolulu of any net profits. To assert that Honolulu would pay out $2,000,000 in money for the chance to recover an *equivalent* amount out of oil in the ground, plus 2½%, or any other percentage, is an attack upon human reason itself. The migratory and uncertain nature of oil has often been a matter of judicial notice. *Bandini Petroleum Co.* v. *Superior Court*, 284 U. S. 8, 19; *Mohawk Oil Co.* v. *Hopkins*, 196 Cal. 148, 152, 236 Pac. 133. One might invest $2,000,000 in Government bonds at 2½%; in industrial bonds, possibly at 5% or 6%; but no reasonable person would invest $2,000,000 in oil in the ground unless the estimates showed a possible realization of several times that amount.

The taxpayer submits, therefore, that the charge that paragraph 8 may be a paper provision is inconsistent with reality; that there is no burden upon the taxpayer to show that paragraph 8 or any other paragraph was not a paper provision; that the charge is now made by the Commissioner for the first time and should not be considered by this Court; that the taxpayer would at least be entitled to have the case remanded to the Board so that it might introduce evidence in this respect; and that in the light of the entire contract, including paragraph 8, the transaction between the taxpayer and Honolulu was not a sale.

III.

Honolulu's right to reimbursement from production does not make the transaction pro tanto a sale, nor affect the character of the payments involved as bonus or advance royalty.

The mere fact that the amounts involved here were payments in advance for oil to be extracted is no objection to an allowance for depletion. This Court stated in *Herring* v. *Commissioner*, 293 U. S. 322, at page 324:

> "A bonus is not proceeds from the sale of property, but payment in advance for oil and gas to be extracted, and is therefore taxable income. As such it is 'gross income from the property' as the phrase is used in Section 204 (c) (2) to designate the base for the application of the percentage depletion."

The Commissioner, however, attempts a distinction by asserting that, inasmuch as Honolulu was entitled to be reimbursed out of production for the payments to the taxpayer totaling $2,000,000, that it had, in effect, purchased an *equivalent* amount of oil from the taxpayer (Brief of Petitioner, pp. 15-22). The notion is clearly impossible. As pointed out above, no reasonable person would pay out $2,000,000 for an equivalent amount of oil in the ground. The payment can only be considered reasonable, or at all sensible, in the light of the entire contract. As such it was advance royalty or bonus, since Honolulu was thereby entitled to continue operating the properties throughout the terms of the leases, paying to the taxpayer one-third of the net profits derived therefrom.

This is, moreover, an attempt on the part of the Commissioner to separate the contract into two contracts, the one pertaining to reimbursement out of production and the other pertaining to the share in the net profits. But the separability of a contract is a question of the inten-

tion of the parties to be determined from the nature of the subject matter and the language of the parties. *Lewis* v. *Shell Oil Co.*, 230 Cal. 80, 29 Pac. (2d) 413. When there is no apportionment of the consideration to the subject matter, the contract is entire and not separable. *Creel* v. *Nettleton*, 151 Wash. 440, 276 Pac. 91; *Buckeye Buggy Co.* v. *Montana Stables*, 43 Wash. 49, 85 Pac. 1077; *Scheland* v. *Erpelding*, 6 Or. 259; *Banks* v. *Crow*, 3 Or. 477; *Boyd* v. *Second Hand Supply Co.*, 14 Ariz. 36, 123 Pac. 619; *Petersburg Fire Brick & Tile Co.* v. *American Clay Machinery Co.*, 89 Ohio St. 365, 106 N. E. 33; *Taplin* v. *Clark*, 89 Vt. 226, 95 Atl. 491. There is no apportionment expressed in the terms of the contract; and an attempt to read into the contract because of the reimbursement provision an apportionment of the $2,000,000 paid to an equivalent amount of oil in the ground would, as already shown, result in an absurdity. The amount paid squares with reason only as a bonus or advance royalty with respect to the entire contract; and as such it is gross income from the property. *Burnet* v. *Harmel*, 287 U. S. 103, 106; *Murphy Oil Co.* v. *Burnet, supra*, 287 U. S. at 302; *Herring* v. *Commissioner, supra.*

The Commissioner urges that a contrary result is to be derived from *Thomas* v. *Perkins*, 301 U. S. 655. There leases were assigned in consideration of the right to receive one-fourth of all oil produced up to an aggregate amount of $395,000. This Court held that the assignor had reserved an interest in the property, to the extent of $395,000, subject to depletion. The Commissioner contends that the interest thus reserved is similar to the one acquired by Honolulu with respect to the amount of oil necessary to reimburse it for its payments to the taxpayer; that, therefore, Honolulu is entitled to depletion with respect to that amount and not the taxpayer. The Commissioner disregards the wide difference in the nature of the transactions. The amounts there received

by Perkins' assignors were gross income to them in their entirety. Here Honolulu, having paid a bonus, is entitled to deduct from the gross receipts from the property each year, an allocable portion of the bonus as rent or royalty. This applies in determining the net income on which the tax is based. *Baton Coal Co.* v. *Commissioner,* (C. C. A. 3) 51 Fed. (2d) 469, certiorari denied, 284 U. S. 674, sustaining the Commissioner and the Board. It applies also in determining the "gross income from the property" on which percentage depletion is based. The Commissioner himself concedes this, for he says (page 20 of his brief): "A true bonus—under the prevailing and plainly correct practice of the Bureau of Internal Revenue—is spread over the entire expected production of the well in computing the depletion allowance of the operator. The allocation is accomplished by deducting from the actual gross proceeds of the operator in the year of production—in order to arrive at the operator's 'gross income from the property'—an amount per barrel equal to the total estimated number of barrels in the well divided by the amount of the bonus."

Thus here, the taxpayer being entitled to depletion on the bonus, Honolulu's depletion is based on its gross receipts less the bonus. As a result, there is no conflict between the taxpayer and Honolulu with respect to their rights to the depletion allowance. The rule laid down in *Helvering* v. *Twin Bell Syndicate Co.,* 293 U. S. 323, that percentage depletion cannot be claimed upon an aggregate basis in excess of 100 per cent of the gross income is thus maintained.

On the Commissioner's theory, on the other hand, the 100 per cent rule of the *Twin Bell Syndicate* case could have no application. He contends that Honolulu purchased, for $2,000,000, an equivalent amount of oil. But the paragraph of the statute relating to percentage de-

pletion (see Appendix, *infra*, p. 30) provides that "in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph." Percentage depletion at 27½ per cent of gross income would necessarily be less than cost depletion where cost is equal to gross income. Thus the Commissioner attempts to apply the 100 per cent rule with a theory which *ipso facto* makes its application impossible.

The Commissioner asserts, however, that the payments here involved cannot, in computing Honolulu's gross income from the property, be spread as a bonus over the entire expected production, because the "terms of the agreement forbid their being spread throughout the life of the well" (Brief of Petitioner, p. 21). The Commissioner, of course, cannot mean that there is anything in the agreement forbidding the proper application of the revenue laws. Perhaps he is concerned by the resulting mathematics.[4] But mathematics far more complicated are

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[4]Adopting the Commissioner's illustration (page 21 of his brief, note 5), suppose that the oil is expected to bring $1.00 a barrel, and that the lessee is entitled to recover the bonus of $100,000 out of production before the lessor's one-eighth royalty begins. Thus the first 100,000 barrels would go entirely to the lessee, plus seven-eighths of the remaining 300,000 barrels, or a total of 362,500 barrels. He has thus paid an advance royalty of $.2759 a barrel. (The Commissioner apparently meant $.2857 instead of $.35 a barrel in his illustration.) However, to even the effect of the one-eighth royalty over the entire production, the advance royalty can be spread over the first 100,000 barrels at $.34375 a barrel, and over the remaining 262,500 barrels going to the lessee at $.25 a barrel. If 10,000 barrels are produced by him in the first year, the sum of $3,437.50 will be deducted by him from the gross proceeds thereof as representing advance royalties; and his deduction for depletion will be 27½ per cent of the remainder.

familiar to the revenue laws and to the Treasury Department.[5] Certainly the taxpayer is not to be denied an allowance for depletion because an extra step is required in the calculation. The statute involved, moreover, requires that the deduction for depletion be "equitably apportioned"; and it would hardly be consonant with equity to give the entire deduction to Honolulu, and deny any to the taxpayer merely because Honolulu was entitled to be reimbursed out of production for the bonus before royalties were due the taxpayer.

The Commissioner further contends, however, that Honolulu "owned" the oil out of which the bonus was to be recovered. He concedes that an interest in the oil property, to be depletable, "need not consist of any form of legal ownership of the mineral content of the land" (Brief of Petitioner, p. 9). He also concedes that in the case of a bonus, the recipient of the bonus is entitled to depletion thereon, and that the gross income of the operator in such

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Applying the above method to the situation here, suppose an expected total production of 40,000,000 barrels and an expected average price of $.50 a barrel, after deducting royalties payable to the original lessors and permittees. Suppose further an average cost of development and production of $.25 a barrel, so as to leave a net profit of $.25 a barrel. The result is that 8,000,000 barrels will be required to reimburse Honolulu for the $2,000,000 bonus paid the taxpayer. The remaining 32,000,000 barrels will, at the same profit of $.25 a barrel, give the taxpayer one-third thereof, or $.08⅓ a barrel. In order to even the effect of this $.08⅓ royalty over the entire production, the $2,000,000 bonus would be spread at the rate of $.11⅔ a barrel on the first 8,000,000 barrels and $.03⅓ a barrel on the remaining 32,000,000 barrels.

[5]See, for example, Treasury Regulations 94, Art. 131-8, and Treasury Regulations 80, Art. 8. See also *Interdependent Taxes,* Commerce Clearing House, Inc. (1937).

case is not the gross proceeds retained by him and obviously owned by him, but such gross proceeds *less an allocable share of the bonus* (Brief of Petitioner, pp. 20-21).[6] He thus concedes that in the case of a bonus a part of the gross proceeds *owned* by the operator represents the depletable interest, not of the operator, but of the person to whom he paid the bonus. On the Commissioner's own presentation, therefore, the necessity of ownership of the oil produced or proceeds thereof during any period does not apply to depletion on bonus or advance royalties. In fact, as shown in *Herring* v. *Commissioner, supra,* it is immaterial whether any production took place during the period involved.

The case of *Thomas* v. *Perkins, supra,* cited by the Commissioner in this connection (pp. 10, 17, 22 of his brief) involved no bonus or advance royalty; and the Commissioner does not contend that it did. He points also (p. 22 of his brief) to the case of *Commissioner* v. *Fleming,* (C. C. A. 5) 82 F. (2nd) 324. The reserved interest of Fleming, however, was limited in aggregate amount, after payment of which he would have no interest left whatever, although production might have hardly begun. Fleming had thus reserved no permanent interest in the property on the basis of which the cash payment could be spread as bonus over the entire expected production of the wells. The Court there itself pointed out, at page 327: "In *Palmer* v. *Bender,* however, the transferor reserved an additional royalty, and so was in reality a sublessor, and the cash paid him could more readily be treated as a bonus

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[6] In his illustration, page 21 of his brief, he points to the *lessee's share* of 10,000 barrels in the first year's production but yet excludes from the gross proceeds thereof $3,500 as advance royalties on which depletion was properly taken by the lessor.

or advance royalty." Here, as in *Palmer* v. *Bender*, the taxpayer had reserved a permanent interest in the properties; and Honolulu was responsible *to the taxpayer* for performing the work required and other obligations under the leases and permits transferred to it, and could only terminate that responsibility by surrendering the propties *to the taxpayer*. The notion of a sale of all the taxpayer's interest except that reserved, applied by the Circuit Court in the *Fleming* case, is therefore not applicable here. It could as well be applied to any transfer for bonus and royalty. Thus, in the Commissioner's illustration (p. 21 of his brief, n. 5) the transaction could be treated as a sale by the lessor, for $100,000, of seven-eighths of the oil in the ground. Again, the transfer in *Palmer* v. *Bender*, supra, for bonus, oil payments aggregating $1,000,000, and a one-eighth excess royalty, could be treated as a sale, for the amount of the bonus, of seven-eighths of the oil in the ground less the amount of the oil payments. The same thing could be done in *Burnet* v. *Harmel*, *Murphy Oil Co.* v. *Burnet*, and *Herring* v. *Commissioner*, *supra*. But this Court in all of these cases condemned the notion of a sale for the amount of the bonus and held the bonus to be gross income from the property. This principle was firmly established even before it became an issue in connection with the income tax. See *Work* v. *Mosier*, 261 U. S. 352, 357-8. Thus, to apply the theory of the Commissioner as he contends would mean uprooting fundamental principles long recognized by this Court.

IV.

The Taxpayer's Reserved Right to Share in the Net Profits of the Well is an Economic Interest in the Oil in Place Subject to Depletion.

The Commissioner attempts, finally, to distinguish the taxpayer's reserved interest because it is measured by the net profits of production instead of by the gross. The distinction is without foundation. One who owns a share in the net income from property has an interest in the property itself. *Brown* v. *Fletcher*, 235 U. S. 589, 598-9; *Irwin* v. *Gavit*, 268 U. S. 161, 167-8; *Senior* v. *Braden*, 295 U. S. 422, 432-3; *Blair* v. *Commissioner*, 300 U. S. 5, 13. Under the law of California, where the property here involved is situated (see map, R. 66), a share in the net profits of oil leases is an interest in the property good against any one but an innocent purchaser. *Shiffman* v. *Richfield Oil Co.*, *supra*. The payments covering such a share in the net profits of oil property are regarded as royalty or rent. *Minnesota Loan & Trust Co.* v. *Douglas*, 135 Minn. 413, 161 N. W. 158, 162; *Akin* v. *Marshall Oil Co.*, 188 Pa. 602, 41 Atl. 748, 751. The deduction of interest at 2½ per cent on Honolulu's advances, in computing the net profit payable to the taxpayer, is immaterial; it is merely a way of distributing profits. *Billwiller's Estate* v. *Commissioner* (C. C. A. 2), 31 F. (2d) 286, certiorari denied, 279 U. S. 866, sustaining the Commissioner. That a share in the net profits of oil property is exhaustible by production is obvious. Thus its owner has an economic interest in the oil in place which is depleted by production. It must follow that he is entitled to the depletion allowance. *Lynch* v. *Alworth-Stephens Co.*, 267 U. S. 364, 370; *Palmer* v. *Bender*, 287 U. S. 551, 557.

The Commssioner refers to his brief in No. 406, pages 7-11. He says there (p. 8) that this Court in *Palmer* v. *Bender, supra,* rejected the criterion of legal ownership of the oil and gas in place for the criterion of ownership of the mineral or its proceeds as produced. There is nothing in *Palmer* v. *Bender* to warrant such a conclusion. This Court did say there (at p. 557) that if the lessor has retained a right to share in the oil produced he has an economic interest in the oil in place, which is depleted by production. It did not say that *only* a right to share in the oil produced represented an economic interest in the oil in place, nor did it say that a right to share in the net profits of the well did not constitute an economic interest in the oil in place. Nor can any such statement be found in *Helvering* v. *Twin Bell Syndicate,* nor in *Thomas* v. *Perkins.* In *Thomas* v. *Perkins* this Court stated, as quoted by the Commissioner in his brief here, at page 10: "If Palmer had retained no interest in the oil he would have been entitled to no deduction on account of depletion. Ownership was essential." It did not say that an interest measured by net profits was not an interest in the oil. It did not say that the ownership which was essential was any particular type of ownership, nor that ownership of a share in the net profits of the well was not sufficient. It is the oil in place which is depleted by production—*Palmer* v. *Bender, supra,* at 557, where this Court said: "If so he has an economic interest in the oil, in place, which is depleted by production." The statute requires that the allowance for such depletion be "equitably apportioned." *Thomas* v. *Perkins, supra,* at 662. The apportionment must depend then upon the interests in the oil in place, and the shares appearing in the gross or net proceeds are only the measure of those interests. Quoting from *Helvering* v. *Twin Bell Syndicate,* this Court in *Thomas* v. *Perkins* stated, at page 662: " 'The apportionment gives respond-

ent 27½ per cent of the gross income from production which it had the right to *retain* and the assignor and lessor respectively 27½ per cent of the royalties they receive. Such an apportionment has regard to the economic interest of each of the parties entitled to participate in the depletion allowances.'" (Italics supplied.) Honolulu does not *retain* the royalty which it pays over to the taxpayer merely because that royalty is measured by net instead of gross proceeds.

In its brief in opposition to certiorari, pages 8-10, the taxpayer pointed out that the very provision of the statute granting percentage depletion based a limitation on the net income from the property; and that the application of this limitation makes the Commissioner's contention mathematically impossible. An example was set out showing that the Commissioner's contention would result in excluding from the net profits the taxpayer's share thereof without any accounting at all. The Commissioner now refers to this argument of the taxpayer's and says (p. 25 of his brief): "No argument or authority is offered to show that the amounts payable to Elbe would not be included within Honolulu's net taxable income." In other words, asks the Commissioner, if the net profits from the property are $60,000, and of this one-third or $20,000 is paid over to the taxpayer as its share under the contract, what argument or authority is offered to show that *Honolulu's* net profit is only $40,000? Is argument or authority necessary? The problem is not one of law but of simple arithmetic. This is true, not only with respect to net taxable income, but also with respect to the net income on which the limitation on depletion is based. The latter, it is to be observed, is not merely the net income from the property, but the net income *of the taxpayer* from the property. (See Appendix, p. 30.)

The Commissioner further says that, even so, the "asserted exclusion of the amounts in question from 'an accounting' would not be invariable, but would depend upon the amount of the operating expense and the size of the share of net profits payable in the particular case." The limitation based on net income is, of course, a limitation on the allowance; and the effect of any limitation depends upon the variables governed by the limitation.[6] The Commissioner is merely defining the term "limitation." In computing the limitation, however, the exclusion of the taxpayer's share of net profits without any accounting at all as a result of the Commissioner's contention would be invariable. It can be demonstrated mathematically that as the statute reads the limitation is required to become effective when the operating expense exceeds 45 per cent of the gross income.[7] As a result of the Commissioner's contention the limitation would become effective when the operating expense exceeds only 17½ per cent of the gross income.[8] This is mathematics purely; and the Commissioner's contention violates the plain words of the statute.

The Commissioner recalls with approval (page 25 of his brief) the taxpayer's statement that percentage depletion

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[6]See Milne, *Academic Algebra*, pages 378-386, Library of Congress catalog number QA152.M65.

[7]Let G=Gross Proceeds
O=Operating Expense
Then Percentage Depletion $=.27\frac{1}{2}G$
Limited, however, to $.50(G-O)$
Therefore, the limit becomes effective when $.27\frac{1}{2}G=.50(G-O)$
Solving for O, $O=.45G$

[8]The corresponding equation would be $.27\frac{1}{2}G=.50(G-O)\frac{2}{3}$
Solving for O, $O=.17\frac{1}{2}G$

is merely a statutory rule of thumb, but contends that the operation of such a rule, on occasion, with apparent arbitrariness, is no ground for rejecting a meaning "which otherwise is plain." The taxpayer agrees with this contention. The Commissioner's argument that the taxpayer's share of the net profits is also Honolulu's net profits, and his attempt to deny the rudimentary principles of mathematics, are no tribute to the plainness of his meaning. On the contrary, his meaning is mathematically in conflict with the plain words of the statute.

It may be observed also that the taxpayer is the discoverer of the oil (R. 34, 70). It is therefore of the very class favored by the policy of the law—for whose benefit, primarily, the special depletion provisions have been enacted. *Palmer* v. *Bender, supra,* pages 558-559. If the taxpayer may borrow the words of this Court there, it would be a strange anomaly if the policy of the law were to be defeated because the taxpayer stipulated for royalties measured by net instead of gross proceeds.

CONCLUSION.

For the reasons stated it is submitted that the respondent had at all times an economic interest in the oil properties involved which is depleted by production; that the payments received by it in 1928 and 1929 in connection with those properties were bonus or advance royalty; that as a result such payments were "gross income from the property" within the meaning of that phrase as used in Section 114(b)(3) of the Revenue Act of 1928, so as to entitle it to a depletion allowance of 27½ per cent thereof; and that the judgment of the Circuit Court of Appeals was therefore correct and should be affirmed.

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January, 1938.

APPENDIX.

Revenue Act of 1928, c. 852, 45 Stat. 791:

"Sec. 23. Deductions from Gross Income.

"In computing net income there shall be allowed as deductions:

* * *

"(l) Depletion.—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In the case of leases the deduction shall be equitably apportioned between the lessor and lessee. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each. (For percentage depletion in case of oil and gas wells, see section 114(b) (3).)

* * *

"Sec. 114. Basis for Depreciation and Depletion.

* * *

"(b) Basis for depletion.—

* * *

"(3) PERCENTAGE DEPLETION FOR OIL AND GAS WELLS.—In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph."